

Decision 04-07-028 July 8, 2004

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Promote
Policy and Program Coordination and
Integration in Electric Utility Resource
Planning.

Rulemaking 04-04-003
(Filed April 1, 2004)

**INTERIM OPINION REGARDING
ELECTRICITY RELIABILITY ISSUES**

Table of Contents

Title	Page
INTERIM OPINION REGARDING ELECTRICITY RELIABILITY ISSUES	2
1. Summary	2
2. Background	2
2.1. Assigned Commissioner's Ruling	4
2.2. Summary of Comments	5
3. Discussion	5
3.1. CAISO and Utility Roles in Assuring Reliability	7
3.1.1. Incremental Improvement	8
3.1.2. Reliance on RMR Contracts	13
3.1.3. Modify Restriction on Use of Bilateral Negotiated Contracts	16
3.1.4. Spot Market Transactions Limitation Relaxed	18
3.2. Application to Southern California and Statewide	20
3.3. Monitoring Plan	22
3.4. Cost Recovery	23
4. California Environmental Quality Act	25
5. Need for Expedited Consideration	25
6. Comments on Draft Decision	26
7. Assignment of Proceeding	27
Findings of Fact	27
Conclusions of Law	29
INTERIM ORDER	31
ATTACHMENT A - Summary of Comments	
ATTACHMENT B - Table of Acronyms	

INTERIM OPINION REGARDING ELECTRICITY RELIABILITY ISSUES

1. Summary

The California Independent System Operator (ISO or CAISO) recently brought important concerns to our attention. In particular, these concerns relate to the CAISO's increasing need to manage congestion and address reliability issues in Southern California, particularly in the area South of Path 15 (SP 15). This has resulted in operational difficulties for the CAISO, along with immediate and important reliability concerns for this summer.

In response, we clarify and modify prior orders because reliability is not only the CAISO's job. We make clear that it is also a utility responsibility to procure all the resources necessary to meet its load, not only service area wide but also locally. In doing so, a utility must take into account not only cost but also transmission congestion and reliability.

These clarifications and modifications specifically apply to the facts presented in Southern California, but the principles also apply statewide. We direct Energy Division to seek information from CAISO and utilities to monitor their responses to this order, and bring any concerns to our attention. This proceeding remains open.

2. Background

In California's hybrid electricity sector, entities must individually and collectively take all appropriate and necessary steps to assure reasonable electric system reliability. Among these entities are generators, privately owned public utilities, municipal utilities, load serving entities (LSEs), the Commission, and the CAISO.

In particular, the CAISO is responsible for ensuring “efficient use and reliable operation of the transmission grid consistent with achievement of planning and operating reserve criteria...” (Pub. Util. Code § 345.¹) In pursuit of these objectives, the CAISO must each day ensure that sufficient generating capacity is on-line and available to meet the forecast system load. This means not only a sufficient amount of on-line generating capacity to satisfy the total system load, but also whether that capacity is in the right place. The CAISO, for example, must have a minimum amount of on-line generation available in certain locations in order to address transmission constraints or other specific operating requirements, such as maintaining proper voltage and other system-stability related requirements. Absent satisfaction of the CAISO’s location-specific operating requirements, the CAISO may be unable to operate the grid reliably.

By letter dated June 10, 2004, the CAISO informed Southern California Edison Company (SCE) and the Director of the Commission’s Energy Division of certain reliability related concerns. The CAISO stated that in recent months it increasingly has had to manage congestion and otherwise address location-specific operating requirements in SCE’s service area in real time, rather than in the day-ahead time frame. This has especially been the case in areas generally defined as South of Path 26, South of Lugo, and North of Miguel. Transmission congestion arises in these areas due, in part, to scheduling of resources that are not deliverable to load. These scheduling practices pose operational difficulties

¹ All statutory references are to the Public Utilities Code unless stated otherwise.

for the CAISO and concerns about reliability, particularly for summer months when the system is stressed.

2.1. Assigned Commissioner's Ruling

On June 10, 2004, the Assigned Commissioner issued an Assigned Commissioner's Ruling (ACR), suggesting that the reliability of the California electric system would be enhanced if utilities considered known and reasonably anticipated congestion on the transmission system when procuring and scheduling resources. Further, he stated that utilities should not only take into account their own direct costs, but also the total costs of their procurement and scheduling, including (to the extent discernable) the costs associated with both system and local area reliability within their service territories. Finally, he recommended that utilities schedule resources so as not to increase known or reasonably anticipated congestion on the transmission system, and to do so in a manner consistent with established and identified reliability requirements.

With these principles in mind, the Assigned Commissioner stated that he intended to propose modifications to several Commission decisions to clarify utility short-term procurement practices. Parties were invited to comment. On June 17, 2004, timely comments were filed and served by SCE, Pacific Gas and Electric Company (PG&E), San Diego Gas & Electric Company (SDG&E), The Utility Reform Network (TURN), Independent Energy Producers Association (IEP), Calpine Corporation (Calpine), Alliance for Retail Energy Markets (AReM), Northern California Power Agency (NCPA), and California Municipal Utilities Association (CMUA).

By Ruling dated June 17, 2004, reply comments were authorized, to be filed by June 21, 2004. Timely reply comments were filed and served by PG&E, SCE, TURN, IEP, CAISO, Office of Ratepayer Advocates (ORA), City and County

of San Francisco (CCSF), and Termoelectrica de Mexicali S. de R.L. De C.V. (TDM). On June 22, 2004, the California Department of Water Resources (DWR) submitted a memorandum to assist the Commission in its deliberations.

2.2. Summary of Comments

All parties support taking reasonable steps to ensure system reliability, including local area reliability and transmission congestion. Parties differ in their views on how this is done, and who is responsible for doing so. Positions range from recommending Commission adoption of the proposals in the ACR to Commission rejection of those principles. Parties' views also differ on the extent to which CAISO can or should be expected to effectively manage the transmission system to achieve efficient use and reliable operation. Parties' positions are briefly summarized in Attachment A.

3. Discussion

The urgency of addressing reliability for Summer 2004 required a shortened period for parties to respond to the ACR. Parties responded quickly with thoughtful and constructive comments and replies. We appreciate their focused work on an expedited schedule.

This order addresses a specific problem associated with stressed CAISO real-time operations stemming from a lack of deliverable resources in the SP 15 zone. This arises from what appears to be SCE's over-reliance on resources that are not deliverable to load in the SP 15 area. When resources are scheduled and procured without regard to their actual deliverability to load or the total cost of procurement (including CAISO re-dispatch costs), the CAISO is forced to line up additional resources to assure that load is served in real-time. For instance, we understand that the majority of must-offer calls occur in SP 15. Large volumes of non-deliverable resources requiring real-time re-dispatch results in operational

challenges and risks to system reliability. The extent to which utilities schedule and procure resources pursuant solely to a least direct cost criterion, ignoring the CAISO re-dispatch costs and reliability implications, can aggravate real-time management of congestion and pose challenges for system reliability.

Reliability-Must-Run (RMR) contracts are contracts the CAISO enters into to assure that units required for local reliability are available. Relatively few RMR units are under contract in the SP 15 area, particularly in SCE's service territory. This is in contrast to other service areas in Northern California and elsewhere (e.g., PG&E and SDG&E). Moreover, the majority of must-offer calls occur in the SP 15 area. These circumstances reflect a relative disconnection between the resources that are scheduled and the ones that are required to serve load in the SP 15 area. The specific situation whereby the CAISO has to re-dispatch the system to make up for non-deliverable resources scheduled or procured by utilities must be addressed, and addressed now, since it affects reliability for summer 2004.

The long-term solutions to these problems will be found in market design changes and the resolution and implementation of resource adequacy issues in this ongoing docket. For this reason, we intend the guidelines outlined in this order to serve as a "bridge" until these longer term issues are fully litigated and resolved. Our goal is to see incremental improvement, not perfection, in addressing the outstanding operational problems highlighted in the CAISO's letter. Therefore, this order will remain in effect through the earlier of year-end 2005 or the issuance of a superseding order or orders addressing these issues in this proceeding.

This order is initiated to clarify past Commission orders to address specific operating and reliability problems associated with scheduling and procurement

practices in a specific area in Southern California. At the same time, however, the principals embodied here are broadly applicable. That is, we want the CAISO to have the best reasonable opportunity to do its job, and to address problems as they arise. To do so, utilities must take congestion and reliability considerations into account (to the extent they are reasonably able to do so) when making immediate, short-term, intermediate-term and long-term scheduling and procurement decisions.

Thus, we rely on the CAISO to take all reasonable steps to enable market participants to increase reliability by scheduling and procuring resources in a manner that minimizes CAISO operational problems while letting CAISO fulfill its fundamental mission of ensuring reliable grid operation. The Commission strongly encourages the CAISO to take steps to provide all Load Serving Entities with the information they require to procure and schedule resources in a manner that supports reliable grid operations. Anything short of the ISO's best efforts in this regard will only serve to perpetuate operational issues and reduce the effectiveness of the efforts the Commission makes in this order.

3.1. CAISO and Utility Roles in Assuring Reliability

The Commission and the Legislature have expressed their clear intent that utilities should procure resources in a manner consistent with utilities' statutory obligation to serve their customers. The utilities' obligation to serve customers is mandated by state law and is a fundamental element of the entire regulatory scheme under which the Commission regulates utilities pursuant to the Public Utilities Act. (See, *e.g.*, §§ 451, 761, 762, 768, 770.) While § 345 clearly assigns the CAISO responsibility for ensuring reliable grid operations, this statutory obligation does not diminish in any respect the utilities' obligation to procure

resources for their loads to ensure reliability. To be clear, it is our view that while the CAISO has the responsibility to ensure and maintain reliable grid operations, it is the LSEs responsibility to have sufficient and appropriate resources to make that reasonably possible.

The CAISO has the authority, experience, knowledge, tools, process and ability to fulfill its responsibility to assure reliable grid operations.² Procurement, however, is not part of CAISO's core functions. The CAISO's ability to operate the system in a reliable fashion is contingent upon utilities fulfilling their responsibility to have sufficient resources to meet load (not just system wide but also locally), and to schedule resources in a manner reasonably consistent with reliable grid operations. As discussed further below, we recognize that the CAISO has the authority to procure resources (e.g., RMR contracts, other types of contracts, must-offer provisions of the CAISO tariff). It is our position, however, that these CAISO tools should not be used to supplant the utility's obligation to procure resources to meet its customer's needs. Rather, the CAISO procurement authority should be a backstop reliability tool.

3.1.1. Incremental Improvement

We first note that it seems many parties read the ACR as a more radical proposal than we think was intended. We do not understand the

² We also note that, according to DWR, many of the identified congestion issues arise as a result of the administration of a DWR contract with Sempra Energy Resources. DWR says that this contract is currently the subject of a dispute being addressed through arbitration, and the Commission's decision may impact the operational administration of the contract. Neither DWR nor any other entity or party, however, provides any other information or any recommendations regarding how today's decision should or should not be made to influence administration of this contract, and positively or negatively affect the congestion and reliability issues presented here.

proposal to, and we do not adopt a policy here, that “abruptly change[s] the regulatory/legal framework for grid reliability that has now existed for 6 years...” (SCE Comments, page 5.) Nor do we adopt “an abrupt about-face from policies that this Commission established only recently in D.04-01-050.” (TURN Comments, page 3.)

What we do is to “help the ISO maintain reliability by providing the utilities additional flexibility in their dispatching decisions...” (PG&E Comments, page 3.) We “remove a perceived disincentive to [utilities] scheduling resources in a manner more consistent with the CAISO’s operating requirements.” (CAISO Reply Comments, page 9.) We also facilitate “incremental improvement in IOU [investor owned utility] scheduling practices...” (CAISO Reply Comments, pp. 3-4.)

The Commission has unambiguously established procurement guidelines recognizing both reliability and least cost objectives while noting the objectives are interrelated and that reliability comes with a cost. For example:

“In making plans to procure a mixture of resources, the utilities should take into account the Commission’s longstanding procurement policy priorities – reliability, least cost, and environmental sensitivity. While each of these priorities is important individually, they are also strongly interrelated. Increased reliability may increase procurement costs.” (D.02-10-062, *mimeo.*, pp. 17-18.)

The Commission has emphasized the importance of taking reliability into account:

“We direct the utilities to include a local reliability component in their next procurement plan. This approach will facilitate a more comprehensive approach to resource planning. It is our intent that this approach will increase the effectiveness of resource procurement and result in lower costs to ratepayers.” (D.04-01-050, *mimeo.*, p. 129.)

Accordingly, a utility scheduling practice or procurement plan that focuses solely on least cost energy, without regard to deliverability of the procured energy to load or to local reliability, is not in compliance with our prior decisions, approved short-term procurement plans, and Assembly Bill (AB) 57.³ SCE in its comments on the draft decision asserts that the Commission is changing a previously approved short-term procurement plan in today's decision. (SCE Comments, pp. 9-10.) This argument misstates the point: this Commission has never required an exclusively least cost focus in its oversight of the IOUs procurement plans, as the preceding citations demonstrate. Furthermore, while SCE states that its focus has been on least cost, we merely provide further guidance in this decision as to what that "least cost" analysis should consider, i.e., the total cost of the IOUs scheduling and procurement practices, including ISO-related costs.

We underscore those principles by emphasizing that utilities should not limit their assessment to least cost day-ahead scheduling and procurement practices but must incorporate all CAISO-related forward commitment costs that result from the utilities' scheduling and procurement decisions. These costs should include all known or reasonably anticipated CAISO-related costs including congestion, re-dispatch, and must-offer costs.

We have always directed, and continue to direct, that utilities act reasonably and responsibly. We emphasize that, as we have directed in prior decisions, reasonable action is not to pursue "least cost" by minimizing only short-term cash flow expenditures.

³ AB 57 adds Section 454.5 to the Public Utilities Code.

Rather, each utility has a duty to provide safe and reliable electricity at a reasonable cost. Reasonable cost means least cost taking into account all relevant factors, such as short run, the long run, cash flow, total cost, safety, reliability and environmental sensitivity. Minimizing total cost, and taking reliability into account, means incorporating all known and reasonably anticipated CAISO-related costs (including congestion, re-dispatch costs and must-offer costs) when evaluating scheduling and procurement options.

In its comments, SCE proposes an alternative means to meet the objectives outlined in the ACR. SCE proposes that the CAISO test the feasibility of adjusting day-ahead schedules to determine whether the schedules would require re-dispatch. The CAISO responds that its existing software does not indicate how to adjust day-ahead schedules in the most effective and least cost way. The CAISO states that it is evaluating interim approaches to manage congestion until Market Design 2002 (MD02) is implemented, but these approaches would not be ready in time to ease operational problems for summer 2004.

SCE's proposal, even if meritorious, does not appear feasible for summer 2004. Therefore, we maintain that improvement to scheduling and procurement practices is an immediate means to address existing operational problems. We encourage SCE to work with CAISO on long-term remedies to improve market design and operation.

Our decision here does not mean that a utility should be cavalier in incurring reliability costs on behalf of persons or entities that are not its customers (e.g., LSEs, energy service providers (ESPs), municipal utilities) and expect to charge those costs to its ratepayers. At the same time, it means

performing a reasonable balance taking into account requests and information provided by the CAISO in this relatively new, complex, hybrid market.

Many parties have raised the issue that the available information for rational decision-making is limited.⁴ For example, utilities argue that the FERC prohibits utility power procurement employees from having access to information from their own company's transmission departments. These restrictions make it impossible for utility employees engaged in procurement to confer with their transmission colleagues who might be better able to "discern" or "reasonably anticipate" reliability issues and CAISO costs. TURN is concerned that, absent specific and accurate information, utility procurement departments "may 'guess wrong' and actually make the situation worse that it was to begin with." (TURN Comments, page 4.)

We seek reasonable, incremental improvements that benefit California. The CAISO is in the process of developing additional information that it may release to all market participants regarding congestion and local reliability constraints. We expect each utility to use whatever information it may lawfully obtain, and that the CAISO may lawfully disseminate (without increasing the market power of any seller), to improve upon the current situation.⁵

⁴ PG&E says its access to information is limited by Standards of Conduct adopted pursuant to Federal Energy Regulatory Commission (FERC) Orders 888, 889 and 2004.

⁵ Based on a preliminary analysis, we do not understand FERC's Order No. 2004 (Standards of Conduct for Transmission Providers, 105 FERC ¶ 61,248 (2003), Order on Reh'g 107 FERC ¶ 61,032 (2004) ("Order No. 2004") to prohibit LSEs from receiving information from the CAISO that is necessary or useful for LSEs to make procurement and scheduling decisions that facilitate the reliable operation of the grid. Rather, Order No. 2004 principally prohibits Transmission Providers from providing transmission

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3.1.2. Reliance on RMR Contracts

SDG&E, PG&E, and others note that the operational and reliability problems the CAISO faces are occurring predominantly in SP 15. Specifically, local reliability issues are being addressed in PG&E's and SDG&E's service territories by RMR contracts. By comparison, SCE's service area has few RMR contracts. TURN, SCE and others maintain that it is the CAISO's responsibility to ensure local reliability by way of RMR contracts, and that the CAISO should do so in SCE's area.

We have been clear, however, that it is our intention to minimize the use of RMR contracts, and that the utilities should include local reliability in their long-term procurement plans for the purpose of reducing the need for RMR contracts. For example, we said:

“They [RMR units] are predominantly in transmission-constrained areas where local generation near load balances the limitation on imports over constrained transmission lines. While RMR serves an important purpose, RMR contracts are annual contracts that detract from a comprehensive infrastructure planning approach. They are also expensive, costing \$360 million in 2003. ... The IOUs in their long-term procurement plans are in a

information to their Energy Affiliates. See 105 FERC at ¶ 52; 18 C.F.R 358.5 (a) and (b) (“the proposed prohibitions prevent a Transmission Provider from giving its Marketing or Energy Affiliates undue preferences over their unaffiliated customers through the exchange of ‘insider’ information”). Order No. 2004 does not apply to ISOs, and so does not appear to prohibit the CAISO from sharing information with LSEs or other market participants. See 105 FERC at ¶ 16, 23; 18 C.F.R 358.1(c). And, of course, the CAISO is not affiliated with any market participant in California. For both of these reasons, Order No. 2004 does not appear to apply to the CAISO. Moreover, Order No. 2004-A specifically provides that a Transmission Provider may “share information necessary to maintain the operations of the transmission system” even with affiliated entities. See 18 C.F.R. 358.5(b)(8).

position to foster a more comprehensive approach to meeting local and system needs through long range plans that incorporate generation, transmission, and demand-side trade-off analysis from a least cost perspective. We direct the utilities to include a local reliability component in their next procurement plan. This approach will facilitate a more comprehensive approach to resource planning. It is our intent that this approach will increase the effectiveness of resource procurement and result in lower costs to ratepayers.” (D.04-01-050, *mimeo*. pp. 128-129).

The recent Assigned Commissioner’s Ruling and Scoping Memo regarding the long-term procurement plans further reinforces the intention to address local resource adequacy and deliverability (e.g., load pockets) by stating:

“Finally, assume that in addition to a general service area-wide requirement, LSEs must satisfy a resource adequacy requirement for any load pockets in their service areas. In preparing and documenting both the input assumptions (e.g., definition of load pockets, load forecasts for such load pockets, resources tabulated by load pocket, etc.) and results (e.g., additional resources required, costs of these additional resources, reduction in RMR costs, etc.) of these two alternative possibilities for the deliverability issue, the differences between these two variants of each Resource Plan should be thoroughly explained.” (Ruling dated June 4, 2004, Attachment A, page 9.)

Our position is that the utilities are responsible for procuring the resources to meet their customers’ needs, including local needs. Although we expect that RMR contracts will remain available as, at a minimum, a backstop mechanism to mitigate local market power in the future, RMR contracts are relatively expensive, especially considering their limited operating parameters. Moreover, they fragment a more comprehensive planning approach from the perspectives both of transmission and overall procurement.

Furthermore, an approach that subsumes local reliability contracts within the scope of utilities' long-term plans is a proactive approach. It reduces vulnerability to price increases and volatility as FERC evolves its pricing and market design policies pertaining to RMR contracts and reliability within load pockets. Indeed, FERC's most recent rulings on the treatment of RMR contracts in connection with the New England Regional Transmission Organization and the Pennsylvania-New Jersey-Maryland Interconnection cast doubt on the long term viability of RMR contracts to serve the goals of local market power mitigation and local reliability.⁶ Given FERC's recent actions with regard to reliability compensation issues and its clear preference for market-based solutions in lieu of RMR contracts in the Eastern ISOs, as well as the relatively expensive and inefficient nature of the existing RMR contracts in California, it is our intention and desire to minimize the use of RMR contracts through IOU scheduling, procurement and comprehensive planning. The Commission believes that consumers are better served from both a cost and a reliability perspective through a proactive planning, procurement and scheduling approach.

In summary, while the Commission understands that some limited (and cost efficient) continuation of RMR contracts may be necessary as a backstop mechanism in the future, a policy that encourages the CAISO to assume greater procurement responsibility in connection with local area reliability would be shortsighted. Moreover, consumers would be ill served by such a short-

⁶ See 107 FERC 61,240, 107 FERC 61,112, and 102 FERC 61,314. FERC's June 2, 2004 order essentially reinforces its March 25 order where it stated that "rather than focusing

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sighted policy. Therefore, we encourage a comprehensive planning approach via IOU scheduling and procurement to minimize the need for RMR contracts. This policy will facilitate better overall resource planning and reduce the potential vulnerability to price and market design changes that could dramatically increase the cost of RMR contracts in the future.

3.1.3. Modify Restriction on Use of Bilateral Negotiated Contracts

D.03-12-062 addressed the appropriateness of utilities' use of bilateral negotiated transactions, and limited their use to specific circumstances.⁷ The decision's list of authorized transactional processes quoted previous decisions that expressed a similar concern and provided authorization only in particular limited circumstances.⁸ The decision noted proposals of PG&E and SCE to expand the circumstances under which bilateral negotiated transactions are authorized. Ultimately, D.03-12-062 limited authorization to three circumstances:

“First, for short-term transactions of less than 90 days duration and less than 90 days forward, the IOUs are authorized to continue to use negotiated bilaterals subject to the strong showing standard we adopted in D.02-10-062, as modified by D.03-06-067. Any such negotiated bilateral transactions shall be separately reported in the utilities quarterly compliance filings.

on and using stand-alone RMR agreements, [ISO-NE] should incorporate the effect of those agreements into a market-type mechanism.”

⁷ “Negotiated bilateral transactions lack transparency and are more appropriately restricted to limited circumstances.” (D.03-12-062, mimeo. page 83, Finding of Fact 16.)

⁸ D.03-12-062, mimeo. page 26.

“Second, utilities may use negotiated bilateral contracts to purchase longer term non-standard products provided they include a statement in quarterly compliance filings to justify the need for a non-standard product in each case. The justification must state why a standard product that could have been purchased through a more open and transparent process was not in the best interest of ratepayers.

“Last, we expand the authorization for use of negotiated bilaterals for standard products in instances where there are five or fewer counterparties who can supply the product, as suggested by SCE. We limit this authority, however, only to the two categories of gas products cited by SCE: gas storage and pipeline capacity. In such instances, the utility needs to affirm that five or fewer counterparties in the relevant market offered the needed product. Any resulting contract shall be separately reported in the utilities’ quarterly compliance filings.” (D.03-12-062, *mimeo.* pp. 39-40.)

The decision concluded that “Negotiated bilateral transactions should be separately reported in the utilities’ quarterly compliance filings.”

(D.02-12-062, *mimeo.* p. 84, Conclusion of Law 11.) It also concluded that there should be limited use: “Where there are five or fewer counterparties in the relevant market, we should authorize the use of negotiated bilaterals for standard products for two categories of gas products cited by SCE: gas storage and pipeline capacity.” (D.03-12-062, *mimeo.* p. 84, Conclusion of Law 15.)

Today we relax the restrictions on negotiated bilateral contracts so that the utilities may take appropriate actions to reduce overall costs and increase local area reliability. In addition to the limited circumstances enumerated in D.03-12-062 at Conclusion of Law 15, we authorize the utilities to engage in bilateral negotiated contracts for capacity and energy from power plants where

the purpose is to enhance local area reliability.⁹ Utilities may include such transactions in their quarterly compliance filings, for approval if there is no objection.

3.1.4. Spot Market Transactions Limitation Relaxed

D.03-12-062 continued a guideline (previously stated in D.02-10-062) that the utilities should plan their market exposure and justify spot market activities that exceed 5% of monthly needs. The decision further explained that:

“this guideline applies to energy procurement in Day-Ahead, Hour-Ahead, and Real-Time markets and it is intended to represent a target amount, rather than a hard limit, as there may be economic reasons justifying a utility’s decision to exceed the target (i.e., least-cost dispatch). We also find that this guideline provides an appropriate balance between procurement flexibility and reliability.” (D.03-12-062, *mimeo.* page 10.)

Finding of Fact 4 states the point precisely:

“The 5% of monthly need target on spot market purchases from D.02-10-062 provides a balance between procurement flexibility and reliability and it is reasonable to continue to require the utilities to justify a higher level.” (D.03-12-062, *mimeo.* p. 81.)

We note that this is a guideline, not a strict limitation. We also provide additional clarification. To the extent that utilities see the need to engage in spot-market transactions to enhance local area reliability, whether on their own accord or in response to information provided by the CAISO, they should do so whether or not those transactions will raise the total percentage

⁹ This authority should not be construed as a change or relaxation of any currently applicable affiliate transactions restrictions.

above 5% of the total monthly need. The utilities should not be restricted by this general guideline from taking actions that enhance local area reliability and reduce overall costs. Of course the utilities may include in their quarterly compliance filings any transactions above the 5% guideline, for approval if there is no objection.

Despite this clarification, however, we continue to emphasize the benefits of avoiding over-reliance on spot-market transactions. That is, we take this action to ensure that utilities have sufficient flexibility to procure in a manner that recognizes deliverability of resources and reduces CAISO real-time operational challenges. This flexibility, should not be interpreted as encouragement to rely on spot markets rather than procuring sufficient capacity in the forward markets. Consistent with the Commission's goal of a robust resource adequacy requirement, our position remains that the vast majority of procurement practices should take place in the forward markets.

3.2. Application to Southern California and Statewide

PG&E and several parties contend that any solution to the problem identified by CAISO should be limited to the area in which the problem is occurring. CAISO, on the other hand, argues that the solution must be statewide. We conclude, as explained below, that the facts presented here relate to one specific geographic area and the policy solution is adopted with a focus on that area. The policy solution, however, applies equally in other areas wherein the same facts prevail, and generally apply statewide as described below.

We are concerned that a generalized policy solution adopted too quickly might cause unintended or harmful consequences. For example, TURN points out that requiring utilities in essentially all cases to change behavior and perhaps incur additional costs at the request of the CAISO for what might be a questionable need for added reliability:

“would create a dangerous disconnect between the party identifying the reliability needs and the parties responsible for the costs of meeting those needs. If these costs will show up ‘on the books’ of the IOUs and not the ISO, there will be no inherent checks and balances in the process. The ISO will not have to weigh the potential for increased procurement costs against the sometimes marginal reliability benefits of a particular change in practice. This will create a powerful incentive for the ISO to over-prescribe reliability requirements in order to make life easier for the system operators, without any effective recourse by the people who pay the bills.” (TURN Comments, page 5.)

We take this concern seriously. We do not intend to create a framework wherein CAISO reliability responsibilities are inadvertently shifted to utilities. Below, we outline a monitoring plan to assess the results of today’s order.

CAISO argues that the policy must be statewide because congestion concerns are not limited to the SCE area. In support, CAISO says that approximately 32 areas of problematic congestion may exist on the grid in the near future, including areas in Northern California. We have no information on the facts behind the approximately 32 additional areas, however, and reach no conclusion based on this assertion.

Nonetheless, we directly apply today’s decision to the area in Southern California wherein the problem has arisen. We also apply these principles to other areas with the same facts causing the same problems. In addition, we apply today’s adopted policy statewide in that we require utilities to act reasonably and responsibly. That utility action, when evaluating resource options, includes minimizing total cost, taking reliability into account, and incorporating all known and reasonably anticipated CAISO-related costs (including congestion, re-dispatch and must-offer costs).

We also expect that neighboring utilities with DWR contacts in SCE's service territory will be scheduling and dispatching those resources in a manner consistent with today's decision.

3.3. Monitoring Plan

Comments have revealed a need to monitor the implementation of this order to assure that it has the desired effect on reducing CAISO real-time operations and associated CAISO-related costs.¹⁰

We ask the CAISO to report back to the Commission within six months (or sooner if necessary) regarding the degree to which utility procurement and scheduling practices, particularly in the SP 15 area, are enabling the CAISO to meet its core mission of reliably operating the grid. We also ask the CAISO to report to the Commission the costs associated with its real-time re-dispatch. It is our belief that compliance with this order should result in reduced CAISO re-dispatch costs. That is, to the extent the utilities, particularly in SP 15, are scheduling and procuring resources in a manner that considers the deliverability of those resources and their congestion related costs, those practices should result in reduced must-offer, congestion, and re-dispatch related costs.

We further ask the ISO and SCE to meet and confer regarding outstanding information issues and provide a joint statement of resolution to the Energy Division. The Energy Division should reference the joint statement in a report to the Commission on the outcome on the efforts to resolve information-related

¹⁰ CAISO is currently in the process of designating Etiwanda Units 3 and 4 as RMR units. Despite an FERC ruling that this capacity had to be offered at cost to the market as compensation for past abuses, and the Commission's D.04-01-050 encouraging utility procurement of this cost-based capacity, the capacity was not contracted for at the last opportunity.

issues. The Commission intends to use the Energy Division report to bring these issues into the record in R.04-04-003.

All of the utilities have raised the issue of market power of sellers. SCE emphasizes that loosening the existing restrictions on bilateral contracting does nothing to resolve the real problem of market power for sellers in the local area. The Commission will monitor market power issues and ask the CAISO and utilities to report to the Energy Division Director any instance of market power impacting the direction provided in this decision.

3.4. Cost Recovery

Utilities may recover costs incurred for reliability purposes consistent with this order. That is, actions taken in furtherance of the directives in this order are deemed consistent with the utilities' already approved short-term procurement plans and thereby subsumed within the protection provided by AB 57. This order, however, makes no modifications of any necessary showings already required of utilities as adopted by the Commission with respect to those procurement plans (*e.g.*, strong standard showing in D.02-10-062, as modified by D.03-06-067; demonstration of reasonableness required in D.03-06-067).

Further, the ACR requested that commenters propose "cost-recovery mechanisms to appropriately recover reliability-related costs from non-IOU load serving entities, such as Direct Access providers and municipal utilities operating in the IOU service territory." Several parties commented on the difficulties that an allocation of reliability-related costs might occasion. (See, *e.g.*, TURN at 3.) Other parties observed that the IOUs already have in place a mechanism by which they may recover reliability-related costs through their FERC-jurisdictional tariffs. (See, *e.g.*, CMUA at 4-5; PG&E Reply at 4).

We expect IOUs to attempt to recover appropriately allocated reliability-related costs through their FERC Reliability Services tariff provisions.¹¹ If utilities are denied recovery through this channel, utilities may seek cost recovery in the appropriate ERRA proceeding. We expect utilities to bring the matter to us with adequate time for reasonable consideration and decision.

Also, while AB 57 provides utilities with considerable cost recovery protection, we agree with TURN that this order is not to be understood as a “blank check.” Rather, the efforts undertaken to procure in a reliable fashion are wholly consistent with the short-term plans approved by the Commission to date.

Finally, “the need for reasonable certainty of cost recovery” is a critical path issue to be decided by the end of 2004. (Scoping Memo dated June 4, 2004, page 4.) To the extent a utility addresses CAISO congestion or reliability concerns via its procurement plan, cost recovery is before us for decision by year-end, and we decline here to prejudge that outcome. At the same time, we repeat our basic criteria. Each utility has a duty to provide safe and reliable electricity at a reasonable cost. Reasonable cost means least cost taking into account all relevant factors (e.g., the short run, the long run, cash flow, total cost, safety, reliability, environmental sensitivity). Minimizing total cost, and taking reliability into account, means incorporating all known and reasonably anticipated ISO-related costs (including congestion, re-dispatch costs and must-

¹¹ For SCE, we understand these to be SCE’s Reliability Services Rate Schedule, Appendix VI to SCE’s Transmission Owner Tariff. For PG&E, we understand these to be PG&E’s Reliability Services Tariff, and/or the Reliability Services Balancing Account in its Transmission Owner Tariff.

offer costs) when evaluating short-term and long-term scheduling and procurement options.

4. California Environmental Quality Act

The California Environmental Quality Act (CEQA) requires that public agencies prepare an environmental impact report whenever the discretionary approval of a proposed project may cause significant adverse impacts on the environment.¹² Certain classes of activities have been determined not to have a significant effect on the environment and are exempt from CEQA.¹³ One of these categorical exemptions applies to the operation and maintenance of existing electric power generation facilities. We believe the clarifications and modifications adopted herein are exempt from CEQA since they pertain to the operation at existing electric power generating facilities.¹⁴ Moreover, to the extent they apply to a new facility (e.g., beginning operation in Summer 2004 or Summer 2005), that facility has been or will be subject to applicable CEQA review when development of the facility is undertaken or proposed.

5. Need for Expedited Consideration

Rule 77.7(f)(9) of the Commission's Rules of Practice and Procedure provides in relevant part that:

“...the Commission may reduce or waive the period for public review and comment under this rule...for a decision where the Commission determines, on the motion of a party or on its own motion, that public necessity requires reduction or waiver of the 30-day period for public review and comment. For purposes of this subsection, "public necessity" refers to

¹² Cal. Pub. Res. Code § 21002.1 (West 2003).

¹³ CEQA Guidelines § 15300.

¹⁴ *Id.* § 15301(b).

circumstances in which the public interest in the Commission adopting a decision before expiration of the 30-day review and comment period clearly outweighs the public interest in having the full 30-day period for review and comment. "Public necessity" includes, without limitation, circumstances where failure to adopt a decision before expiration of the 30-day review and comment period...would cause significant harm to public health or welfare. When acting pursuant to this subsection, the Commission will provide such reduced period for public review and comment as is consistent with the public necessity requiring reduction or waiver."

We balance the public interest in (a) quickly clarifying and modifying decisions and procedures to enhance electric system reliability for Summer 2004 against (b) the public interest in having a full 30-day comment cycle on the proposed modifications. We conclude that the former outweighs the latter. The clarifications and modifications adopted herein affect public health, safety and welfare. Any delay in implementing these clarifications and modifications would cause significant harm to public health and welfare by unreasonably and unnecessarily compromising system reliability, particularly in the constrained area at issue. We seek valuable public review of, and comment on, our proposed changes, and find that a reduced period balances the need for that input with the need for timely action.

6. Comments on Draft Decision

On June 28, 2004, the draft decision was filed and served on parties in accordance with Pub. Util. Code § 311(g)(1) and Rule 77.7 of the Commission's Rules of Practice and Procedure. On July 1, 2004, comments were filed by CAISO, Calpine, IEP, ORA, PG&E, SCE, SDG&E, TURN, and the Western Power Trading Forum. The Commission did not entertain reply comments. The Commission has considered the parties' comments in light of the requirement

that comments must focus on factual, legal or technical errors in the draft decision, and that comments merely rearguing parties' positions will be accorded no weight (Rule 77.3 of the Commission's Rules of Practice and Procedure). Consistent with Rule 77.3 we have made various changes to the draft decision. These revisions range from the correction of minor typographical errors to more detailed revisions. We add a sunset provision specifying the end point of this decision; we augment the cost recovery discussion to ensure clarity vis-à-vis AB 57; we revise the draft decision to address market power and informational concerns raised in the comments of CAISO and certain other parties; we add text noting our concern that neighboring utilities who have DWR contracts in SCE's service territory not make the reliability situation worse; finally, we clarify the discussion of ultimate cost recovery in the context of matters also subject to FERC review.

7. Assignment of Proceeding

Michael R. Peevey is the Assigned Commissioner. Mark S. Wetzell, Meg Gottstein, and Carol Brown are the assigned Administrative Law Judges and Principal Hearing Officers in this proceeding.

Findings of Fact

1. The CAISO is responsible for ensuring efficient use and reliable operation of the transmission grid consistent with achievement of planning and operating reserve criteria.
2. Satisfaction of CAISO's location-specific operating requirements affects its ability to operate the grid reliably.
3. In recent months, CAISO has had to increasingly manage congestion and otherwise address location-specific operating requirements in SCE's service area

in real time, rather than in the day-ahead time frame, especially in areas generally defined as South of Path 26, South of Lugo, and North of Miguel.

4. Transmission congestion arises in these areas due, in part, to scheduling of resources that are not deliverable to load.

5. These scheduling practices pose operational difficulties for the CAISO, and concerns about reliability, particularly for summer months when the system is stressed.

6. While the CAISO has the responsibility to ensure and maintain reliable grid operations, it is the LSEs responsibility to have sufficient and appropriate resources both system-wide and locally to make that reasonably possible.

7. The Commission has unambiguously established procurement guidelines recognizing both reliability and least cost objectives, while noting that these objectives are interrelated and that reliability comes with a cost.

8. The Commission has emphasized the importance of taking reliability into account in procurement and scheduling of resources.

9. Each utility has a duty to provide safe and reliable electricity at a reasonable cost.

10. Reasonable cost means least cost taking into account all relevant factors (e.g., short run, long run, cash flow, total cost, safety, reliability, environmental sensitivity).

11. Minimizing total cost and taking reliability into account means incorporating all known and reasonably anticipated CAISO-related costs (including congestion, re-dispatch costs and must-offer costs) when evaluating scheduling and procurement options.

12. The Commission intends that utilities minimize the use of RMR contracts, and include local reliability in their long-term procurement plans for the purpose of reducing the need for RMR contracts.

13. Reasonable relaxation of restrictions on negotiated bilateral contracts, by authorizing utilities to engage in bilateral negotiated contracts for capacity and energy from power plants, will allow utilities to take appropriate actions to reduce overall costs and increase local area reliability.

14. Reasonable clarification of guidance on reliance on spot market transactions provides greater flexibility to utilities in taking actions to enhance local areas reliability without encouraging over reliance on spot market transactions.

15. Comments have revealed a need to monitor the implementation of this order to assure that it has the desired effect on reducing CAISO real-time operations and associated CAISO-related costs, and to determine whether or not the beneficial consequences sought from today's order in fact materialize.

16. The clarifications and modifications adopted herein are exempt from CEQA since they pertain to the operation at existing electric power generating facilities and new facilities which will themselves be subject to CEQA.

17. Any delay in implementing the clarifications and modifications adopted in this order will cause significant harm to public health and welfare by unreasonably and unnecessarily compromising system reliability.

Conclusions of Law

1. Each utility is responsible for scheduling and procuring sufficient and appropriate resources (both system-wide and locally within its service area) to meet its customers' needs, and to permit the CAISO to maintain reliable grid operations.

2. A utility scheduling practice or procurement plan that focuses solely on least cost energy, without regard to deliverability of the procured energy to load or to local reliability, is not in compliance with our prior decisions, approved short-term procurement plans, and AB 57.

3. When making scheduling and procurement decisions, each utility should incorporate all CAISO-related forward commitment costs that result from the utility's decisions, including all known or reasonably anticipated CAISO-related costs, such as congestion, re-dispatch, and must-offer costs.

4. Utilities should use a comprehensive approach to scheduling and procuring resources that reasonably minimizes the need for RMR contracts.

5. The restrictions on negotiated bilateral contracts should be relaxed so that the utilities may take appropriate actions to reduce overall costs and increase local area reliability by contracting for capacity and energy from power plants when the purpose is to enhance local area reliability; utilities should be allowed to include such transactions in their quarterly compliance filings, for approval if there are no objections.

6. To the extent that utilities see the need to engage in spot-market transactions to enhance local area reliability or reduce costs (whether on their own accord or in response to information provided by the CAISO) they should do so, whether or not those transactions raise the total percentage above the 5% of total monthly need guideline; utilities should be allowed to include any transactions above the 5% guideline in their quarterly compliance filings, for approval if there is no objection.

7. Today's decision should apply to the area in Southern California wherein the problem has arisen; to areas where the same facts are causing the same problems; and statewide to the extent utilities should include minimizing total

cost in their evaluation of resource scheduling and procurement options, taking reliability into account, and incorporating all known and reasonably anticipated CAISO-related costs (including congestion, re-dispatch and must-offer costs).

8. CAISO and SCE should meet and confer to resolve any outstanding informational issues between them, and then report to the Energy Division Director consistent with the preceding discussion in this decision.

9. Utility actions taken in furtherance of the directives in this order should be deemed consistent with the utilities' already approved short-term procurement plans, and thereby subsumed with the protection provided by AB 57.

10. An environmental impact report is not required since today's order is categorically exempt from CEQA.

11. This order should be effective today to prevent significant harm to public health and welfare, and secure electrical system reliability without delay.

INTERIM ORDER

IT IS ORDERED that:

1. Utilities shall follow the principles stated in the body of this order when they make resource scheduling and procurement decisions including:

- a. Each utility is responsible for scheduling and procuring sufficient and appropriate resources (both system-wide and locally within its service area) to meet its customers' needs, and to permit the California Independent System Operator (CAISO) to maintain reliable grid operations.
- b. A utility resource scheduling practice or procurement plan that focuses solely on least cost energy, without regard to deliverability of the procured energy to load or to local reliability, is not in compliance with our prior decisions and approved short-term procurement plans pursuant to Assembly Bill (AB) 57.

- c. When making resource scheduling and procurement decisions, each utility shall incorporate all CAISO-related forward commitment costs that result from the utility's decisions, including all known or reasonably anticipated CAISO-related costs, such as congestion, re-dispatch, and must-offer costs.
- d. Each utility shall use a comprehensive approach to scheduling and procuring resources that reasonably minimizes the need for reliability must-run contracts.

- e. Restrictions on negotiated bilateral contracts are relaxed so that a utility may take appropriate actions to reduce overall costs and increase local area reliability by contracting for capacity and energy from power plants when the purpose is to enhance local area reliability. Utilities may include such transactions in their quarterly compliance filings, for approval if there is no objection.
- f. A utility may exceed the 5% monthly guideline for spot-market transactions to enhance local area reliability or reduce costs, and may include transactions above the 5% guideline in their quarterly compliance filings, for approval if there is no objection.

2. Today's decision applies to the areas in Southern California generally defined as (a) South of Path 26, South of Lugo and North of Miguel, and (b) South of Path 15. It also applies to areas where the same facts cause the same problems. Moreover, it applies statewide to the extent utilities shall include minimizing total cost in their evaluation of resource scheduling and procurement options, taking reliability into account, and incorporating all known and reasonably anticipated CAISO-related costs (including congestion, re-dispatch and must-offer costs).

3. Utilities shall, and CAISO is requested to, provide data to the Commission, when and as requested by the Energy Division Director, to monitor the effect of today's order.

4. Utility action taken in furtherance of the directives in this order shall be deemed consistent with the utilities' already approved short-term procurement plans.

5. This order shall remain in effect through the end of 2005, or the issuance of a superseding order or orders addressing the same issues in this proceeding, whichever occurs earlier.

6. This proceeding remains open.

This order is effective today.

Dated July 8, 2004, at San Francisco, California.

MICHAEL R. PEEVEY
President

CARL W. WOOD
GEOFFREY F. BROWN
SUSAN P. KENNEDY
Commissioners

I reserve the right to file a concurrence.

/s/ CARL W. WOOD
Commissioner

I reserve the right to join
Commissioner Wood's concurrence.

/s/ MICHAEL R. PEEVEY
President

I reserve the right to file a dissent.

/s/ LORETTA M. LYNCH
Commissioner

ATTACHMENT A
SUMMARY OF COMMENTS
Page 1 of 4

The CAISO generally supports the proposals in the ACR, and applauds the Commission's initiative and proposed quick action by decision in early July 2004. Further, CAISO contends that RMR contracts are an inferior tool for achieving reliability, SCE's scheduling proposal cannot be implemented in the timeframe needed to meet the goals of the ACR, the policies in the ACR should not be limited to only the SCE area, and the potential cost-shifting impact of the ACR is not inequitable. The CAISO also agrees to provide supplemental information to market participants in a manner that does not increase the ability of generators to exercise locational market power.

IEP supports the goals sought in the ACR, but is concerned about the process that led to consideration of these extraordinary steps. Nonetheless, recognizing the apparent urgency, IEP recommends as an expeditious resolution that (a) the Commission encourage utilities to enter into contracts to meet system and local reliability needs and (b) the CAISO enter into short-term reliability contracts (STRCs) to backfill Summer 2004 needs to the extent utility/supplier contracts are inadequate.

Calpine generally concurs that utilities should be obligated to enter into STRCs to procure energy for local reliability needs for summer 2004 and summer 2005, with two modifications. First, after summer 2005 a load pocket procurement obligation should become an integral component of an LSE's formal procurement planning process. Second, Calpine endorses IEP's proposal on STRCs.

TDM, TURN, SCE, CCSF, PG&E, ORA and others express reservations about adopting the ACR's proposals. Many believe too much is proposed too quickly.

ATTACHMENT A
SUMMARY OF COMMENTS
Page 2 of 4

TDM is concerned that the speed with which major policy changes are considered and adopted here may lead to unintended or harmful consequences. Others express concern whether the policies, even if adopted and implemented now, can achieve the desired goals as quickly as summer 2004.

TURN, SCE, CCSF believe that without adequate information, time and process, the ACR contemplates both (a) fundamental changes in statutory relationships that have been in place for several years, and (b) abrupt changes in policy adopted as recently as January 2004 (in D.04-01-050).

PG&E argues that the solution, if any (a) should not be statewide but should concentrate on specific locational issues; (b) should not be implemented by utilities but can and should be implemented by the CAISO (via designating additional RMR units); but (c) if utilities are expected to participate in the solution, then CAISO must provide clear and specific direction to utilities, with utility-incurred costs fully recoverable from utility ratepayers.

SCE also believes the CAISO can and should take the lead and resolve the issues within existing authority. If further solution is needed, SCE proposes that the CAISO modify its day ahead scheduling procedures to test the feasibility of managing intra-zonal congestion, with any "reliability premium" paid by all grid users, and cost recovery for utilities assured when utilities implement the CAISO's directions.

ATTACHMENT A
SUMMARY OF COMMENTS
Page 3 of 4

SDG&E supports the ACR's objectives, but is concerned that the short time provided for comments does not permit a full discussion of the complexities raised by the ACR. SDG&E is also concerned that, even with additional information provided by CAISO, utilities will not have the benefit of the full scope of information possessed by CAISO. SDG&E recommends that CAISO post "proxy" locational marginal prices to address congestion costs and mitigation incentives pending implementation of MD02. SDG&E also suggests in the longer term that necessary transmission infrastructure projects be built.

ORA states that it is possible that DWR contracts are complicating the problem since utilities must also dispatch DWR contracts. ORA encourages the Commission to slow down and not rush to judgment without more and better information. ORA recommends that the Commission ask CAISO to provide updated information on the outlook for summer 2004 with Etiwanda Units 3 and 4 as RMR units. If no urgent problem exists, ORA recommends a slower, more deliberate approach to deal with needed improvements, including assessment of options and costs. As a bridge to MD02, ORA suggests considering (a) STRCs and (b) CAISO tariff changes (e.g., SCE and SDG&E proposals).

AReM, NCPA and CMUA generally assert that ESPs and their customers are already fully paying their own costs with regard to system reliability, and reliability related costs should be borne solely by utilities and their bundled customers. NCPA also urges that any solutions be limited to the geographic areas where the problem arises.

ATTACHMENT A
SUMMARY OF COMMENTS
Page 4 of 4

TURN recommends Commission rejection of the proposals in the ACR. TURN believes the Commission should urge the CAISO to address local reliability needs through RMR contracts, STRCs, and other mechanisms.

DWR cautions that changes in procurement or scheduling to enhance reliability should be done with consideration of the impacts, if any, on recovery of DWR's revenue requirement. Also, DWR notes that many of the identified congestion issues arise as a result of the administration of DWR's contract with Sempra Energy Resources. DWR says that this contract is currently the subject of a dispute being addressed through arbitration, and the Commission's decision could impact the operational administration of the contract.

(END OF ATTACHMENT A)

**Attachment B
Table of Acronyms**

ACRONYM	ITEM OR ENTITY
AB	Assembly Bill
ACR	Assigned Commissioner's Ruling
AReM	Alliance for Retail Energy Markets
CAISO	California Independent System Operator
Calpine	Calpine Corporation
CCSF	City and County of San Francisco
CMUA	California Municipal Utilities Association
DWR	California Department of Water Resources
ESP	Energy Service Provider
FERC	Federal Energy Regulatory Commission
IEP	Independent Energy Producers Association
LSE	Load Serving Entity
MD02	Market Design 2002
NCPA	Northern California Power Agency
ORA	Office of Ratepayer Advocates
PG&E	Pacific Gas and Electric Company
RMR	Reliability must run
SCE	Southern California Edison Company
SDG&E	San Diego Gas & Electric Company
STRC	Short term reliability contract
TDM	Termoelectrica de Mexicali S. de R.L. de C.V.
TURN	The Utility Reform Network

(END OF ATTACHMENT B)